SENATE FINANCE COMMITTEE
Testimony Statement of B. John Williams
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INTRODUCTION

Mr. Chairman, Senator Grassley, Members of the Finance Committee, I appreciate the opportunity to speak before you today about corporate tax shelters. The issue is a high priority in the Office of Chief Counsel as well as in the Internal Revenue Service and the Department of Treasury. I would like to speak today about some of the problems we face in dealing with these transactions and about the measures the Office of Chief Counsel plans to take to address those problems. At my confirmation hearing in November, I made two points which you urged me to follow up on: (1) the IRS must use available tools more effectively to gather information and increase compliance; and (2) the IRS must use that information in a more effective and timely manner. As the Office of Chief Counsel brings its resources to bear on the tax shelter issue, the measures we are taking will reflect this dual objective.

The Committee also requested subsequent to that hearing a written report detailing the IRS's current approach to the tax shelter problem and any proposals to improve compliance and enforcement in this area. At the time, last November, I committed to provide that report by March 31, 2002. With the delay in my confirmation, however, and given the nature and scope of the request, I find it is necessary to ask for an extension. I hope that the Committee will consider my testimony today to constitute an interim report. I will follow up with a more formal written report on May 31. I appreciate your understanding in this matter.

ISSUES AND RESPONSES

I believe there are three major issues faced by the IRS in dealing with tax shelters. First, determining whether certain transactions are "abusive" is a difficult call and does not lend itself to fast answers. Second, the IRS has fallen behind the marketplace in identifying and addressing abusive transactions. Finally, the disclosure, registration and list maintenance rules have produced limited results. All three issues, and the ways in which we solve them, are interrelated. I am pleased to report to you that the IRS, the Office of Chief Counsel and the Treasury Department are taking steps to address them.

Determining what is "Abusive"

Perhaps the most important and difficult issue is the question of what constitutes an "abusive" transaction. Some transactions are indisputably "abusive" - these tax

shelters are based on misstatements of law or outright fraud. They are shams in fact, and the government's response to them requires no complex policy calls. The tax shelters we are discussing today, however, are sophisticated transactions based on technical arguments, and it is less clear when they are truly "abusive." Some transactions may be technically sound and are therefore not necessarily "abusive," even though the government may not like them. Shutting them down may require a change in law either by amending regulations or new legislation. Other transactions take advantage of ambiguities or gaps in the tax law, or they interpret current law in a manner not previously contemplated by the government. These transactions often may seem to work on their face, but they lack economic reality or do not adhere to long-standing tax principles. These latter transactions are "abusive." The facts and circumstances of specific transactions must be examined to distinguish apparently technically sound transactions from "abusive" ones that do not work under current law.

Identification of Tax Shelters

This Committee's work over the past couple of years has shown that it is not easy to define the difference between legitimate tax planning and "abusive" transactions that do not work under current law. While not easy to define, transactions that are abusive can be recognized, if spotted. For this reason, the best tool we have in dealing with them is early identification. There are two ways to identify these transactions. First, the IRS may identify transactions through the examination process. Second, taxpayers and promoters are required to disclose or register questionable transactions. Identifying questionable transactions early could permit the IRS to gather information and issue guidance, in some cases even before the transactions show up on tax returns. Notifying the public of the IRS's position with respect to current transactions coupled with a vigorous enforcement of the disclosure, registration and list maintenance requirements should discourage taxpayers from playing the audit lottery and participating in abusive transactions.

Although early identification is critical to stemming the tide of abusive transactions, the IRS has had difficulties identifying and responding to these transactions in a timely manner. Too often the IRS is behind the marketplace. The IRS's lack of timeliness is caused by several factors, some of which may be out of the government's control. First, the typical examination function of the IRS is not positioned to scrutinize a transaction until several years after it has been marketed. Second, many abusive transactions are difficult to identify on a tax return. Third, once transactions are identified, there has been a disconnect between revenue agents, field counsel and technical counsel in the National Office that has resulted in significant time delays.

One major conclusion I have reached is that the IRS must rely upon disclosure and registration to gain any chance of addressing questionable transactions early. Current disclosure and registration roles are complicated and need to be simplified and harmonized. Changes in these rules announced yesterday by Treasury should, in my view, increase IRS access to necessary information and permit an adequate factual

and legal analysis of questionable transactions even while they are being marketed. I will address these issues later in my testimony.

Internal Coordination - Tax Shelter Tax Forces

Organizationally, the IRS and the Chief Counsel's office are positioned to eliminate the disconnect between the various functions. Larry Langdon and I have discussed this issue and have developed some solutions. Historically, abusive transactions that are identified in the field must make their way up the line from agent to field counsel to technical counsel in the National Office, resulting in extensive delays. After National Office counsel review the problematic transactions, too often there has been inadequate follow up in factual investigation of these transactions by agents and field counsel. Within the Chief Counsel's office, inadequate coordination of review of potential issues among the technical and operating divisions has contributed to significant delay.

Issuing guidance requires IRS operating units to work together with Counsel field and technical experts to consider these transactions, including preparing analysis for joint review by the Office of Chief Counsel and Treasury. Traditionally these units have worked sequentially, requiring extended amounts of time. To address this problem of internal delays, the Office of Chief Counsel and the Large and Mid-Size Business Division ("LMSB") have agreed to implement transaction-specific task forces. The task forces would be formed for specific transactions or a group of transactions, and would include attorneys from the appropriate operating divisions of Chief Counsel, attorneys from the technical divisions of Chief Counsel, the Department of Treasury, and the Office of Tax Shelter Analysis. In addition, revenue agents would be assigned to each task force. Being dedicated to the task force would reduce the distraction of other obligations that detract from a focus on these issues.

Use of such task forces should allow us to distinguish between sound and problematical transactions, determine the kind of guidance necessary and permit both follow-up on the transaction and prompt issuance of public guidance. Decisions on whether to issue a Notice alerting taxpayers that the IRS will challenge a transaction will be made jointly and early. The hope is that we will become aware of these transactions even before they are reported on a tax return and be able to address them early in their promotion. Public guidance, if needed, can be issued promptly. The task forces will achieve consistency through the system, coordinating the efforts of the National Office, the field attorneys, the revenue agents and Appeals. Furthermore, cross-checking of issues identified in the field with disclosure and registration becomes easier. This means a higher likelihood that taxpayers who have invested in questionable transactions will be identified and subject to examinations.

The process will start with a review of registered transactions by the Office of Tax Shelter Analysis ("OTSA") working with Chief Counsel's LMSB division. As new transactions are identified, a preliminary determination will be made as to which

transactions warrant referral to a task force. A task force will comprise members from OTSA, the appropriate Division Counsel (LMSB, the Small Business and Self-Employed Division ("SBSE"), or the Tax Exempt and Government Entities Division ("TEGE")), and the appropriate technical divisions. This composition ensures that technical expertise will be available from the start. The task force will decide whether to recommend (1) factual investigation of the transaction, (2) further inquiry of the promoter, and/or (3) issuance of public guidance. Revenue agents who will be a part of the task force will conduct any factual investigation with assistance of division counsel. If further information is needed (e.g., list of investors) from the promoter, it will be requested. Treasury attorneys will be asked to join the task force if it is determined that public guidance should be considered.

The Committee may be aware that on Monday the IRS published Notice 2002-21, which targets transactions involving the use of a loan assumption agreement to claim an inflated basis in assets. This Notice was the product of a task force I formed shortly after my arrival at the IRS a couple months ago. The task force included attorneys from my office, the technical divisions of Chief Counsel, LMSB, and Treasury. The group worked together to quickly analyze the transaction and issue the Notice. The use of transaction-specific task forces such as this should greatly increase the timeliness of the IRS's response to abusive transactions and should go a long way towards fixing the problems of internal communication and coordination.

Public Identification - Published Guidance

The published guidance program is an important tool in the tax shelter area that can be used to increase disclosure and compliance. Because our federal tax system is based on self-assessment, the IRS has a responsibility to assist taxpayers in determining what works and what does not. The current level of published guidance is unacceptable to the Commissioner and to the public. According to a study performed in the course of considering how to redesign the IRS, in 1998, the IRS published merely 15% of the number of revenue rulings published in 1979. Furthermore, in 1979, 97% of these rulings dealt with substantive issues; in 1998, this number dwindled to 38%.

The IRS must respond to transactions more quickly. Our delays mean more taxpayers will enter into these transactions. While abusive transactions will be challenged upon audit even where they have not yet been addressed by public guidance, informing the public that we are aware of such transactions will encourage disclosure and should often discourage participation in abusive transactions. Showing that we are aware of transactions currently in the market, and of who has invested in them, should also reduce taxpayers' incentive to play the audit lottery. Our commitment to serving the public demands that we announce early our views on new transactions that do not work, and our views on those that do.

Some transactions that raise concerns are technically sound under current law. Our willingness to issue guidance addressing the transactions that work should

encourage promoters and taxpayers to come to us with transactions that they believe are technically sound. If promoters and taxpayers know that the IRS is not simply a nay-sayer, they should be more interested in talking to us about transactions and financial instruments currently being developed. As a result, the IRS would be better informed of current transactions, and would be able to recommend necessary changes to the law, whether administrative or legislative, more quickly.

Issuing guidance quickly on transactions that are abusive requires us to develop our principal position and announce it early rather than attempting to refine all the possible arguments that might apply. Too often published guidance is delayed while we attempt to formulate the perfect solution to all potential problems. We should focus instead on developing excellent advice that covers the general issues; more specific problems can be addressed in later guidance. The Office of Tax Policy and the Office of Chief Counsel are committed to early and joint policy review to increase the level of published guidance. Joint efforts should allow us to remain on top of current transactions.

Disclosure and Registration - Administrative Proposals

Becoming current with the market must be a top priority. If the IRS must rely only on information from examinations to identify transactions, however, internal efforts to respond as quickly as possible will have little effect. Even in the best of circumstances, large corporate returns generally are not filed until nine months after the close of the tax year, and examination is not completed until several years after that. This means the IRS may not become aware of the transaction until several years after it has been marketed and taxpayers have entered into it.

Thus, the IRS is not always able to identify abusive transactions promptly through return examination and often must rely upon disclosure and registration to catch transactions. The limited results under these rules has hampered the IRS's ability to identify transactions currently in the market. The rules are complicated, and they can be construed very narrowly, while exceptions can be construed very broadly. Many taxpayers are construing them in such a way that the taxpayers are able to conclude that the rules do not apply to their particular transaction. Thus we need disclosure, registration and list maintenance requirements that are simpler, broader and more integrated with the application of the section 6662 penalties.

Treasury, the IRS and the Office of Chief Counsel have worked together to develop administrative and legislative changes that will address these problems. A primary goal of these proposals is to provide clearer rules, without exceptions and loopholes, that will be easier for taxpayers and their advisors to understand and easier for the IRS to administer and enforce. First, our proposals would broaden the range of persons who are required to register reportable transactions and maintain lists of investors. Promoters have not complied with these rules in the past because they have argued that they are not an organizer or seller of the tax shelter and thus do not have a

reporting obligation. The proposals would also require individual taxpayers, partnerships and trusts, not just corporations, to disclose their participation in reportable transactions. Additionally, receipt of these disclosures would be centralized at one location, as are corporate disclosures, to provide for coordinated review by OTSA. These changes thus should cover a large number of promoters and taxpayers who have participated in reportable transactions, and it should expose a larger number of transactions currently in the market.

The proposals also would amend the rules under sections 6011, 6111 and 6112 of the Internal Revenue Code to establish a consistent definition of a "reportable" transaction for disclosure, registration and list maintenance purposes. Because taxpayers and promoters are reading the exceptions in the current rules liberally and interpreting the requirements narrowly, a clear and consistent rule is needed. This would ensure that the IRS has multiple sources of information about a reportable transaction and gives the IRS the ability to move quickly between the various forms of information. For example, if a taxpayer fails to disclose a reportable transaction, the IRS would be able to move quickly from a registration to an investor list in order to identify that taxpayer and other non-disclosing taxpayers.

The proposals would clarify the definition of "listed transaction." Taxpayers have applied the "substantially similar" standard narrowly to conclude that disclosure is not required. The regulations would be amended to provide that the term "substantially similar" includes any transaction that is designed to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. This change should prevent more taxpayers from avoiding disclosure. The proposals also would discourage taxpayers from participating in transactions based on the invalidity of a regulation without disclosure. Reliance on opinions asserting that a regulation is invalid will not be a defense to the accuracy-related penalties unless proper disclosure is made. Finally, the administrative proposals would apply the accuracy-related penalties under section 6662 if a listed transaction is not disclosed and results in an underpayment.

Disclosure and Registration - Enforcement Activities

These changes to the disclosure, registration and list maintenance rules combined with focused task forces should result in broader identification, quicker public guidance, and better compliance. I have committed to the IRS the support of the Office of Chief Counsel in obtaining the information it needs to determine whether taxpayers and promoters are in compliance with these rules. The IRS has authority under current law to investigate the adequacy of disclosure statements by seeking information from both promoters and investors. Promoters are required to register tax shelters with the IRS and maintain a list of investors in the transactions. Furthermore, any person who claims a deduction, credit or other tax benefit by reason of a "reportable" transaction must disclose the transaction on their return. The IRS is exercising its authority under the Internal Revenue Code to determine whether taxpayers are in compliance with

these registration and disclosure requirements. The IRS is gathering this information through the use of Information Document Requests (IDRs) and summonses to promoters. I have personally committed to the Commissioner and to the Division Commissioners (LMSB, SBSE, TEGE) whatever support is needed to pursue these matters.

Under this authority, the IRS has requested information from 30 promoters thus far to determine whether they have complied with the registration and list maintenance requirements. Our attempts to remain current with the market, however, are hampered by these promoters' failure to cooperate. Many of these letters were issued over eighteen months ago, and the promoters still have yet to provide us with any information. Specifically on these current matters, I have instructed Chief Counsel attorneys to issue summonses for the information we have requested and to pursue enforcement vigorously. Two summonses have already been issued, but more must follow. Once the information is gathered, we will be prepared to act quickly upon that information if further investigation or published guidance is warranted.

We are presently seeking legislation that would allow the government to seek injunctive relief against promoters who repeatedly disregard the registration and list maintenance requirements. Some promoters are blatantly ignoring the rules regardless of the penalties they face. An injunction would place a promoter in a public proceeding under court order to comply with the rules. Failure to comply in the future would place the promoter in contempt of court. Even the threat of such an injunction (and the associated publicity) should be enough to end noncompliance.

CONCLUSION

The Office of Chief Counsel is committed to supporting the IRS in its efforts to address tax shelters and to remain current with respect to transactions occurring in the marketplace. We will assist in identifying and analyzing transactions to determine whether published guidance or legislative changes are needed. When needed, we will provide published guidance in a timely manner. We will help the IRS gather the information it needs to determine whether promoters and taxpayers are in compliance with disclosure, registration and list maintenance rules, and we will work with the IRS in processing the information it receives. This commitment should help resolve the issues faced by the IRS in dealing with tax shelters.

Thank you, Mr. Chairman, for giving me the opportunity to speak today. I will gladly answer any questions the Committee may have.